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William Roger Abbott

U. S. Taxpayers' Exclusion of Income Earned Abroad—Rules and Limitations

by William Roger Abbott II
Senior Accountant, Caracas Office

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The right of a U. S. taxpayer to exclude foreign income from gross income is subject to several types of limitations, the most important one being that the income excluded must have been income earned by the taxpayer. The next limitation is that the earned income must relate to the services the taxpayer renders in a foreign country. This relationship is established by the fact of residency or physical presence in a foreign country. These two limitations have been features of the Internal Revenue Code for many years.

The third limitation, relating to the amount of the exclusion, has also been part of the Code for many years, but it has not affected a great number of taxpayers until the last few years. Until 1963, only the U. S. citizen qualifying under the 17-month rule was subject to limitation on the amount of his exclusion, and it has always been $20,000. However, the Revenue Acts of 1962 and 1964 extended monetary limitations to the U. S. citizens who qualified under the bona fide residence rules and established limitations on two levels. From 1963 on, a taxpayer qualifying as a bona fide resident with less than three years' residence may not exclude more than $20,000 a year of his foreign-source earned income. This rule is still in effect under the 1964 Act. However, taxpayers who either have been bona fide residents for more than three years before 1963 or complete this term of residence at any time after 1962 enjoy a higher limitation. For the tax years 1963 and 1964 this limitation was $35,000, but the Revenue Act of 1964 reduced it to $25,000. As a result, most taxpayers will be concerned with either the $20,000 or the $25,000 limitation, unless they are contemplating the filing of amended returns relating to years before 1965.

PRORATING UNDER RESIDENCE RULE

These are the broad general limitations. They are subject to special rules created by special circumstances of the taxpayer. The most common situation requiring special rules is that of prorating the exclusion limitation. It is not ordinarily possible for the taxpayer to begin or end his presence or residence in a foreign country at midnight of December

31. The limitation is calculated on an annual basis; therefore, the taxpayer must prorate it over the part of the year he is qualified to use it. A U. S. citizen who arrived in Venezuela November 1, 1964 will be able to exclude 61/365ths of $20,000, which is about $3,340, of the income he earned in Venezuela to the end of 1964. If this taxpayer stayed in Venezuela during 1965 and did not leave until March 1, 1966, then he will be entitled to exclude a maximum of $20,000 during 1965, but only 59/365ths of $20,000 in 1966, which is about $3,200, assuming that he otherwise meets the bona fide residence tests. The requirement of prorating exclusion limitations also applies to taxpayers who have completed three years of uninterrupted bona fide residence. If a taxpayer does not date his bona fide residence from January 1, 1961 or before, he has been or will be required to prorate. Since three years of bona fide residence are necessary before a taxpayer can enjoy the higher exclusion, he will be required to prorate the different limitations in the year he completes the three years' residence.

As an example, let us assume that a U. S. citizen establishes bona fide residence in Venezuela on November 1, 1962 and that he receives cash compensation of $25,000 a year. In 1962, he has no proration problem because the monetary limitation of the exclusion was not then in effect. In 1963 and 1964, he is entitled to a maximum exclusion of $20,000 in each year. In 1965, he completes three years of uninterrupted bona fide residence on November 1, and is entitled to the higher exclusion for the remainder of 1965. To compute his exclusion, he will add 304/365ths of $20,000 to 61/365ths of $25,000. His exclusion limitation for 1965 is about $20,835.

PRORATION UNDER PHYSICAL-PRESENCE RULE

Proration is required under the 17-month rule of physical presence. In the foregoing example, the taxpayer entering in 1962 and qualifying only as to physical presence would prorate his exclusion limitation for the last two months of 1962, and his maximum would be 61/365ths of $20,000, or about $3,340. When he completes a full year from January 1 to December 31 in a foreign country, he is entitled to the maximum of $20,000, even though all his earnings do not come from the same country and even though he is not working part of the time. This means he could work sixteen months in Venezuela, take a month's vacation in Barbados, and work or vacation the final month in the U. S. Of course, he may not exclude income from sources within the U. S.

It often happens that a taxpayer is in a foreign country a considerable time before he can qualify as a bona fide resident. In such a case he should try to qualify under the 17-month rule even though he will become a bona fide resident before the end of that time. If he is able to qualify under both the physical-presence test and the tests for bona fide residence, it makes no difference that the relevant time periods overlap. By planning his affairs so that he is present in foreign countries for the required time, he enjoys the exclusion from the date of his arrival and not from the later time when bona fide residence may have been established.

DEFERRED COMPENSATION

The next special rule of importance relates to amounts received after the close of the taxpayer's year but related to services performed in a prior year. The 1962 Act put in the requirement that compensation not received within one year after the close of the taxpayer's year is not excludable as foreign-source earned income. However, this special rule affects only amounts to which the taxpayer did not have a right on March 12, 1962. Normally, the payment of *Utilidades*[1] would qualify to be included in the income of the year to which it relates, but *Antiguedades*[2] and *Cesantia*[3] payments relating to periods after March 12, 1962, and not accrued on services performed in the year of payment or preceding year, may not be excluded from gross income. It is possible to avoid having a large sum of taxable income falling in one year by paying the accrued Labor Law benefits of *Antiguedades* and *Cesantia* to the employee or to a trust fund in which he has a vested interest. These deferred compensation payments are taxable in the year in which they are paid, unless the taxpayer is able to fit them into the exclusion of some prior year.

NON-CASH COMPENSATION

So far, I have dealt with cash compensation of the taxpayer. The 1964 Act requires that non-cash benefits received by the taxpayer be included in gross income. Non-cash compensation is usually taken to

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[1] *Utilidades:* an annual profit-sharing bonus prescribed by Venezuelan Labor Law; it may go as high as two-months' pay.

[2] *Antiquedades:* a long-term service premium accruing at the rate of 15-days' salary for each year of service.

[3] *Cesantia:* a lump-sum unemployment compensation accruing at the same rate as *Antiquedades*. Both *Cesantia* and *Antiquedades* are payable at termination of employment under conditions prescribed by Venezuelan Labor Law.

mean the value of rent-free housing, use of a company car, free medical services, and so on. It does not include such cash items as overseas differential pay, cost-of-living allowance, or other fringe benefits paid to the taxpayer. Before 1964 the value of non-cash benefits was ignored for income-reporting purposes. In 1964, ⅓ of this compensation must be reported, and in 1965, ⅔. For 1966 and subsequent years the full amount is to be reported. This requirement has the effect of raising the exclusion limitation for 1964 and 1965. Taking the previous example where the taxpayer earned $25,000 a year and began bona fide residence on November 1, 1962, let us further assume that he receives non-cash benefits worth $6,000 a year. In 1962 he has no limitation on excludable income. In 1963, his exclusion is limited to $20,000, but, since he is not required to include non-cash benefits, his exclusion is in reality $26,000. In 1964, he is required to include ⅓ of the non-cash compensation in gross income, so his limitation is reduced to $24,000. In 1965, it is further reduced, but since he now qualifies for the $25,000 exclusion at November 1, his exclusion turns out to be $22,835.

COMMUNITY PROPERTY

There is a special rule stated in section 911 (c) (3) regarding jurisdictions having laws relating to the division of property acquired by either spouse during marriage, usually recognized under the term "community property laws." This difficult and complex aspect of section 911 is not within the scope of this paper. For present purposes, I think it is sufficient to say that when both spouses are U. S. citizens, they will not enjoy any so-called double exclusion, since the Code specifically states that the exclusion is to be computed as though the community property laws did not exist. Of course, when both husband and wife have foreign-source earned income and otherwise qualify under the rules of residence or physical presence, each is allowed to compute a separate exclusion, even though a joint return is filed. For the purposes of filing, each spouse should prepare a separate Form 2555.

U. S. GOVERNMENT EMPLOYEES

Employees of the United States or its agencies are not entitled to exclude foreign-source income earned in that employment. This rule extends to include partners of partnerships contracted by the government or its agencies, but only insofar as their distributive shares of partnership profits are concerned. If a partner is paid a salary that is not a distribution of profits and otherwise qualifies for the exclusion, the salary may be excluded from his gross income, subject to the usual limitations.

PARTNERSHIPS

Partners of partnerships in which both personal services and capital are material income-producing factors are subject to a special rule that only 30% of their distributive share of the partnership profits may be considered as earned income. If the partnership has a large foreign-source income in relation to total income, the effect of this rule may severely limit a partner's maximum exclusion. If the partner's share of foreign-source partnership income is less than the maximum exclusion ($20,000 or $25,000) and his total share of partnership income is less than $66,667 (or $83,333), he would be better off as an employee, assuming that a similar salary would not be deemed to be a distribution of profits.

Deductions and Exemptions

So far, this discussion has been limited to what a U. S. citizen residing abroad may exclude from gross income. If, after computing the amount of gross income that may be excluded, there remains a balance that will be taxable, the taxpayer will be interested in reducing it by the amount of any deductions and exemptions to which he is entitled.

Personal exemptions for the taxpayer and his dependents are deductible in full from gross income in excess of the foreign-source earned income excluded. However, where the taxpayer's wife is not a citizen and has not been resident in the U. S. during the entire year, he cannot file a joint return; and further, no personal exemption for her is allowed if she has income derived from U. S. sources. Subject to this limitation, the taxpayer and his wife may enjoy the further exemptions for blindness and for being over 65 years of age. The taxpayer is not required to report any income obtained by his wife if she is an alien and nonresident in the U. S., unless it comes from U. S. sources and is joint income. If a taxpayer is prevented from filing a joint return, he may be able to file as a head of household if he has dependent children and so obtain about half the rate benefits he lost by not being able to file jointly. Exemptions for dependent children are allowed in full.

Expenses related to foreign-source earned income are deductible only to the extent such income is not excluded. Suppose that a bona fide resident, who in 1965 is entitled to a $25,000 exclusion, earns $40,000 and that his business deductions relating to this income are $4,000. Then 25/40ths of the $4,000 relates to the $25,000 excluded, so the remaining 15/40ths or $1,500 is all that is deductible. Many taxpayers receive expense allowances for which they may or may not be required to make an accounting to their employer. When there is an adequate accounting to the employer, the taxpayer will be required to include in gross income only the excess of allowances over expenses, but when the expenses exceed the allowances, he will be required to allocate this excess between income excluded and income reported. If an adequate accounting is not made to the employer, the entire expense allowance must be included in gross income and is considered foreign-source earned income. Any expense deductions to which the taxpayer may be entitled will be allocated between the exclusion and the balance of gross income, with only the latter portion deductible.

Personal deductions—interest on a home, taxes, medical expenses, and so forth—are allowed in full against the excess of income over excludable foreign-source income and business expenses. Certain expenses are deductible no matter where incurred. These are real estate taxes, income taxes of countries other than the U. S., interest, casualty or theft losses, and medical expenses, subject, of course, to the limitations relating to these expenses. Charitable contributions are deductible only if made to charities in the United States. Any foreign tax other than real estate taxes and income taxes are not deductible. In the United States, state and local taxes are deductible. They are normally limited to income taxes, real estate taxes, personal property taxes, sales and use taxes, and gasoline taxes. The standard deduction may be elected in lieu of itemizing deductions; however, this election limits deductions to $1,000 and does not allow use of the foreign tax credit.